Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:CHI:2:TL-N-2383-01
CAGruber

date: JUN 26 2001

to: Joseph Schaefer, Revenue Agent

from: Associate Area Counsel (LMSB), Chicago

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ubject: [redacted]-**Change of Accounting Method Ceasing to Engage in a Trade or Business**

Background: On May 1, 2001, this office provided an opinion relating to whether, as a result of the sale of the canning and bottling plants in [redacted] and [redacted], respectively, [redacted] must take into income, during those years, the remaining balance of the I.R.C. § 481 adjustment. It was our opinion that the sale of the [redacted] plants constituted a termination of a trade or business within the meaning of Treas. Reg. § 1.448-1(g)(3)(iii) and Rev. Proc. 92-19. Consequently, this office recommended an adjustment to income.

On or about [redacted], the taxpayer was given a draft Form 5701 proposing an adjustment of $[redacted] to income for tax years [redacted] and [redacted]. The taxpayer submitted a response on [redacted]. This memorandum replies to the taxpayer's [redacted] memorandum. It should not be cited as precedent. The issue has been coordinated with Industry Counsel, Joseph Grant.

Analysis: The taxpayer argues that the sale of the [redacted] operations is not a cessation of a trade or business. It contends it is in the business of manufacturing and selling [redacted] and that all vertically integrated manufacturing processes are components of the taxpayer's overall trade or business of manufacturing and selling [redacted].

The taxpayer relies on the facts that it did not maintain separate books and records nor did it file a separate Form 3115, as required in Rev. Proc. 92-20, Section 6, for the [redacted] plants. Therefore, it argues, the [redacted] operations cannot be a separate trade or business. It also contends that the Consent Agreement "explicitly defines [redacted] as 'the taxpayer'" and that "'the taxpayer, a Corporation, manufactures [redacted] and employs the overall accrual method of

accounting.'" [1] It argues that the IRS was aware of [redacted]'s [redacted] operations prior to issuing the Consent Agreement and had ample time to indicate therein an intent to treat such operations as separate trades of businesses of [redacted]. Lastly, it argues the disposition of the can and bottle making operations would fail the "substantially all" threshold of Rev. Proc. 77-37, 1977-2 C.B. 568, provided in Sec. 8.03(2) of Rev. Proc. 92-20.

In addressing the arguments of the taxpayer, an underlying presumption must be kept in mind, which is, the methods of accounting should clearly reflect income on a continuing basis, and that the Service will exercise its discretion under sections 446(e) and 481(c) of the Code in a manner that generally minimizes distortions of income across taxable years and on an annual basis. Rev. Proc. 92-20 was designed to encourage prompt compliance with proper tax accounting principles, and to discourage taxpayers from delaying the filing of applications for permission to change an impermissible accounting method. See Rev. Proc. 92-20, Section 1.

It should also be noted that what [redacted] is attempting to do, distorts income. But for the § 481 adjustment, the entire gain from the sale of the [redacted] plants, relating to the inventory valuation, would have been reported in [redacted] and [redacted], rather than spreading approximately $[redacted] over [redacted] years.

As stated in the Memorandum dated May 1, 2001, Section 8.03(2) contains a **nonexclusive** list of transactions that are treated as the cession of a trade or business. Two of the transactions listed, (1) sale of a trade or business, to which the net § 481(a) adjustment related, to another taxpayer in which I.R.C. § 1060 applies; and (2) a division of a corporation ceases to operate the trade or business to which the net section 481(a) adjustment relates, apply herein. The taxpayer filed Forms 8594, Asset Acquisition Statement under Section 1060 for both dispositions.[2] Secondly, [redacted] sold the [redacted] **divisions** of the company which had a net § 481 adjustment of approximately $[redacted] resulting therefrom.[3]

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[1]This appears to be some sort of estoppel argument attempting to limit the Service's ability to challenge the sale of the [redacted] operations.

[2]The taxpayer did not dispute this fact or argument.

[3]The taxpayer did not dispute this fact or argument either. See Memorandum dated May 1, 2001 for a fuller discussion of this

The taxpayer's primary argument is that since it did not maintain separate books and records for the [redacted] operations, it could not cease to operate a trade or business when it sold the [redacted] operations. The taxpayer relies upon the language of Section 10.04(1) of Rev. Proc. 92-20 for support.

Section 10.04(1) states:

> Sections 1.446-1(d)(1) and (2) of the regulations provide that when a taxpayer has two or more separate and distinct trades or business, a different method of accounting may be used for each trade or business provided the method of accounting used for the trade or business clearly reflects the income of the taxpayer and of that particular trade or business. No trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business.

Unfortunately, the taxpayer's interpretation of the revenue procedure is out of context. In this case, the entire [redacted] operation is on the accrual method of accounting. [redacted] does not need to maintain separate books and records for the [redacted] divisions because it employs the same method of accounting for the entire company. **Only** in the situation where it wished to employ different methods of accounting does the Code require separate books and records. See Treas. Reg. §§ 1.446-1(d)(1) and (2) wherein it clearly states "for purposes of this paragraph" taxpayers must maintain separate books and records for such trade or business. Nowhere in the Code or case law does the lack of separate books and records, alone, indicate that no trade or business exists.[4]

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issue and the taxpayer's treatment and characterization of the divisions. The taxpayer admits the [redacted] operations were handled as cost centers using cost accounting principles for management control and reporting purposes. Moreover, the accounting department prepared monthly statements of assets and liabilities and fixed and variable costs for each [redacted] manufacturing plant. Finally a theoretical cost savings from [redacted] was computed for purposes of providing management an ability to reasonably assess the economics associated with meeting varying levels of consumer demand for [redacted] in light of underlying capacity constraints.

[4]Although the phrase "trade or business" appears frequently in the Code, it does not contain a general definition and the Treasury has not issued a regulation which defines the term for general purposes. Commissioner v. Groetzinger, 480 U.S. 23, 27

Likewise the taxpayer's lack of filing two separate Forms 3115 does not mean there was no separate trade or business. Only one Form 3115, to change a method of accounting, is required because the taxpayer employed only one accrual method of accounting. Furthermore, the fact that the Service did not treat the [redacted] operations as separate trades or businesses in the Consent Agreement is not important for two reasons. One, the method of accounting was consistent for the entire [redacted] operation. Two, Section 8.03(2)(a)(iv) of Rev. Proc. 92-20 states a **division** ceasing to operate a trade or business will be treated as a cessation of a trade or business for purposes of accelerating the § 481(a) adjustment period. It is also important to note that the taxpayer sold the [redacted] operation before it signed the Consent Agreement and there is no indication the fact of the sale was conveyed to the Service.

[redacted] also argues that the dispositions of the [redacted] operations fail the "substantially all" threshold of Rev. Proc. 77-37. Yet it offers no explanation for this proposition. For clarification, Section 8.03(2) states a "taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease **or** substantially all of the assets of the trade or business are transferred to another taxpayer. With respect to [redacted], it **ceased** to operate the [redacted] operations when the divisions were sold to [redacted] and [redacted], respectively. Therefore the "substantially all" test does not apply. Moreover, a review of the respective asset purchase agreements indicates that virtually all of the assets were sold. The taxpayer has provided no evidence to prove less than "substantially all" of the assets were sold.

Lastly, the taxpayer disputes the applicability of the holding in Hospital Corporation v. Commissioner, 107 T.C. 73 (1996). It attempts to distinguish itself from Hospital based upon the lack of separate books and records for the [redacted] operations. As stated previously, it is not the lack of business records alone, which determines a "trade or business". Additionally, the fact that § 448(d)(7) allows a hospital to account for its § 481 adjustment over 10 years does not affect the application of Treas. Reg. § 1.448-1(g)(3)(iii) to [redacted].

As stated in the May 1, 2001 Memorandum, in the absence of the acceleration provision, a taxpayer could contravene the general duplication of an item of income or expense as a result of a change in the method of accounting, by merely restructuring its business. Under such circumstance, the taxpayer would distort

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(1987).

overall lifetime income. Hospital, 107 T.C. at 88. Without an acceleration of the § 481 adjustment, by the Service, to [redacted]'s income during the years [redacted] and [redacted], there is a distortion resulting from the sale of the [redacted] operations.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Associate Area Counsel
(LMSB), Chicago

By: (Signed) CHRISTA A. GRUBER
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6/26/01

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:CHI:2:TL-N-LO-2383-01
CAGruber

date: MAY 01 2001

to: Joseph Schaefer, Revenue Agent

from: Associate Area Counsel, Chicago
Large and Mid-Size Business

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ubject: [redacted]-**Change of Accounting Method Ceasing to Engage in a Trade or Business**

This memorandum responds to your request for assistance. It should not be cited as precedent. The issue has been coordinated with Industry Counsel, Joseph Grant.

Issue: Whether, as a result of the sale of the [redacted] plants in [redacted] and [redacted], respectively, [redacted] is required to take the remaining balance of any § 481(a) adjustment relating to the [redacted] plants into account in computing taxable income for [redacted] and [redacted].

Conclusion: Yes.

Facts: [redacted] is in the business of manufacturing and selling [redacted] beverages and employs the overall accrual method of accounting. On or about [redacted], in accordance with section 6.04 of Rev. Proc. 92-20, 1992-1 C.B. 685, [redacted] filed an Application For Change in Accounting Method (Form 3115) for [redacted] with the National Office of the Internal Revenue Service. The application concerned changes in the taxpayer's method of reporting the cost of spare parts and supplies for its entire business operation. [redacted] requested permission to change its method of reporting the cost of certain spare parts and supplies (hereinafter referred to as "spare parts") which had been expensed when purchased.[1]

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[1]Certain parts were acquired at the same time as (and as an initial complement to) various items of machinery and equipment. [redacted] capitalized the cost of these spare parts and depreciated that cost over the same period as the equipment to which it related. No change was proposed in [redacted]'s method of accounting for said spare parts.

Under the new tax method of accounting, [redacted] proposed expensing all spare parts when used. The section 481 adjustment was computed by taking the total spare parts balance on [redacted], backing out spare parts which were being depreciated and backing out an amount which had been capitalized previously.

The section 481 adjustment was computed as follows and spread over a six-year period.

Total balance of spare parts @ [redacted]	$ [redacted]
Less: Previously capitalized spare parts	($ [redacted])
Net tax basis of depreciating spare parts	($ [redacted])
Plus: Rounding	$ [redacted]
Total section 481 adjustment	**$ [redacted]**
Adjustment to taxable income over six years	**$ [redacted]**

A spreadsheet provided by the [redacted] indicated that the $[redacted] of spare parts affected by the change in method were located at the company's [redacted] and [redacted] plants. [redacted] has not disposed of the [redacted], therefore the adjustment relating to spare parts located at the [redacted] is being allowed.

However, $[redacted] of the spare parts related directly to the [redacted]. The Container Division comprised of [redacted] plants were disposed of during [redacted] and the [redacted] was disposed of during [redacted]. The Revenue Agent is proposing to require [redacted] to take into income the remaining portion of the § 481(a) adjustment relating to the [redacted] plants pursuant to Rev. Proc. 92-20 because [redacted] has ceased to engage in a trade or business.

The following time line illustrates the background of the request for a change in method of accounting and the sale of the [redacted] divisions.

[redacted]	Outline letter of intent to sell [redacted]'s [redacted] facilities to [redacted]
[redacted]	Inter-Office (VP Purchasing to Pres) recommendation to proceed with spending the capital to upgrade the [redacted] vs. selling. (Never spent money to upgrade).
[redacted]	Application for Change in Accounting Method sent to IRS.

[redacted]	District Counsel, North Atlantic Region, no objection to change in accounting method for the spare parts.
[redacted]	Revised proposal from [redacted] relating to the purchase of the [redacted] facilities and the corresponding long-term supply agreement. Proposal valid thru [redacted].
[redacted]	U.S. Dept. Of Justice, Tax Division, no objection to the change in accounting method for the spare parts.
[redacted]	Confidentiality Agreement between [redacted] and [redacted] regarding the acquisition of the [redacted] plants and subsequent supply arrangement.
[redacted]	Recommendation by [redacted] management to sell [redacted] plants.
[redacted]	IRS Memorandum requesting R/A to provide written statement of eligibility for [redacted] under the provisions of section 6.04 of Rev. Proc. 92-20 as of 1/29/93.
[redacted]	Form 1120-[redacted], incorporated [redacted] Schedule K of the Form 1120 provided that [redacted], was in the business of manufacturing [redacted].
[redacted]	Board of Directors Minutes for [redacted], stating dispose of substantially all of the assets of its [redacted] plants located in [redacted]; [redacted]; [redacted] and [redacted]
[redacted]	Acquisition Agreement, dated [redacted], among [redacted], as buyer; [redacted], as seller; and [redacted], as transferee.
[redacted]	Consent Agreement-IRS and [redacted] granting permission to change method of accounting for spare parts.
[redacted]	Recommendation by [redacted] management to pursue sale of [redacted] plant to [redacted]
[redacted]	Property disposal Request-sale of [redacted] as divestiture of the [redacted] process.
[redacted]	[redacted] signed Consent Agreement.

[redacted]	Inter-Office -regarding sale of [redacted] bottle manufacturing business to [redacted]
[redacted]	Board of Directors Minutes for [redacted] stating it is in the best interest of the corporation to dispose of [redacted].
[redacted]	Asset Purchase Agreement between [redacted], as seller, and [redacted], as buyer, dated [redacted].

The Application for Change in Accounting Method made no mention of [redacted]'s interest in selling the can facilities or the bottling plant, nor were the sales disclosed prior to final approval of the change in accounting method by the IRS.

The [redacted] plants were sold in [redacted] of [redacted] and about the same time negotiations began to sell the [redacted] plant. The Property Disposal Request document for the Sale of [redacted] manufacturing business/[redacted] plant was dated [redacted]. [redacted] signed the [redacted] Property Disposal Request on [redacted]. Therefore, [redacted] had either sold or was in the final stages of disposing of the [redacted] plants before the Consent Agreement was signed.

Analysis: Section 481 was enacted during 1954. It was designed to prevent items of income or expense from being omitted or duplicated as a result of a change in method of accounting initiated by the taxpayer or the Government. S. Rept. 1622, 83d Cong., 2d Sess. 307-311 (1954). Section 481(c) provides that a spread of the § 481(a) adjustment over a period of more than one year is allowed only as permitted under the regulations. Treas. Reg. § 1.481-4 provides that a § 481(a) adjustment may be taken into account under the terms and conditions agreed to by the Commissioner and the taxpayer.

Treas. Reg. § 1.448-1(g)(3)(iii) provides that if a taxpayer ceases to engage in the trade or business to which the § 481(a) adjustment relates, or if the taxpayer operating the trade or business terminates existence, and such cessation or termination occurs prior to the expiration of the adjustment period described in paragraph (g)(2)(i) or (ii) of this section, the taxpayer must take into account, in the taxable year of such cessation or termination, the balance of the adjustment not previously taken into account in computing taxable income. For purposes of this paragraph (g)(3)(iii), the determination as to whether a taxpayer has ceased to engage in the trade or business to which the § 481(a) adjustment relates, or has terminated its existence, is

to be made under the principles of § 1.446-1(e)(3)(ii) and its underlying administrative procedures.

Rev. Proc. 92-20 provides general procedures under Treas. Reg. § 1.446-1(e) for obtaining the consent of the Commissioner to change a method of accounting. Paragraphs 8.03(1) through 8.03(3) of Rev. Proc. 92-20 describe situations which will cause the immediate acceleration of a net § 481(a) adjustment. The paragraphs state a reduction in inventory value; ceasing to engage in the trade or business; and subsequent LIFO elections will cause the immediate acceleration of the net § 481(a) adjustment. It is the Service's contention that [redacted] has ceased to engage in a trade or business and therefore, the net § 481(a) adjustment relating to the canning and bottling plants must be taken into income immediately. Section 8.03(2)(a) contains a nonexclusive list of transactions that are treated as the cession of a trade or business. Sale of a trade or business, to which the net § 481(a) adjustment relates, to another taxpayer in which I.R.C. § 1060 applies, and a division of a corporation ceasing to operate the trade or business to which the net section 481(a) adjustment relates, are two transactions listed. See Rev. Proc. 92-20, Section 8.03(2)(a)(ii) and (iv).

[redacted] has stated that Section 8.03(2)(a)(ii) does not apply because it did not sell its trade or business. It contends it manufactured and sold [redacted] before and after the sale of its [redacted] company. It also contends Section 8.03(2)(a)(iv) does not apply because the sale of the [redacted] plants and the [redacted] company did not cause it to cease to operate the trade or business to which the net section 481(a) adjustment applied.

Although [redacted] manufactured and sold [redacted], it also manufactured [redacted] to be used by the [redacted]. The [redacted] plants were separate divisions of [redacted]. Each plant was given a plant code for separately tracking its costs. It must also have considered the [redacted] operations to be a separate trade or business because the Acquisition Agreement between [redacted] and [redacted], dated [redacted] specifically stated:

> [redacted], through its [redacted] Division, is engaged in the business of [redacted] and ends (the "Business"). [redacted] desires to sell the Business to [redacted], and [redacted] desires to purchase the Business on the terms and conditions contained in this Agreement.

Also the Asset Purchase Agreement between [redacted] and [redacted]

[redacted] defined business as "[redacted] business of [redacted] as part of the [redacted] segment of the United States [redacted] market."

The February 28, 1994, inter-office memorandum discusses the sale of the [redacted] bottle manufacturing business. It is a request from [redacted] to [redacted] to approve the divestiture of the [redacted] manufacturing business through a sale of the operation to [redacted].

Lastly, [redacted] filed a Form 8594, Asset Acquisition Statement under Section 1060 for each disposition.

The Service has taken the position that a taxpayer ceases business when there is an elimination of the taxpayer's business completely or when there is a sale or termination of one of several businesses being conducted by the taxpayer. See Hospital Corporation, Id., at 89-90, (wherein the Court found that the taxpayer, which owned, operated and managed hospitals, ceased operating businesses when certain hospital facilities were sold to a third-party). The Service has also taken the position that where a corporation maintains different divisions for each trade or business and one of the divisions ceases to engage in its trade or business, the corporation ceases to engage in that trade or business and, therefore, must include in income any remaining portion of a § 481(a) adjustment relating to the division's trade or business. Id., at 93.

Absent a provision similar to the cessation-of-business acceleration provision, any portion of a § 481(a) adjustment being reported ratably over a number of years that had not yet been accounted for at the time a taxpayer ceased to engage in the trade or business to which the adjustment relates, might be omitted from the income or the trade or business which gave rise to that § 481(a) adjustment. Hospital Corporation. v. Commissioner, 107 T.C. 73, 88 (1996). Thus in the absence of the acceleration provision, a taxpayer could contravene the general intent of § 481(a), which is to prevent the omission or duplication of an item of income or expense as a result of a change in the method of accounting, by merely restructuring its

business. Under such circumstances, the taxpayer would distort its overall lifetime income. Id.

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